United Nations E/2004/50

Economic and Social Council

Distr.: General
8 April 2004

Original: English

Special high-level meeting
26 April 2004

Coherence, coordination and cooperation in the context of the implementation of the Monterrey Consensus

Note by the Secretary General*

Summary

The present note provides background information and raises a number of questions (highlighted in bold type) for consideration at the 2004 special high-level meeting of the Economic and Social Council with the international financial and trade institutions in relation to the three themes selected to focus this year's discussion: (a) impact of private investment and trade-related issues on financing for development; (b) the role of multilateral institutions in reaching the Millennium Development Goals; and (c) debt sustainability and debt relief. The first theme covers the following three sub-themes: investment climate and sustained economic growth, including the role of the private sector; external capital flows, including foreign direct investment; and trade-related issues. The second theme also covers three indicated sub-themes: monitoring the Millennium Development Goals; the poverty reduction strategy paper process and other development tools; and financing the Millennium Development Goals, including new and innovative sources. The section on the third theme, debt sustainability, is divided into two sub-sections: one related to heavily indebted poor countries and one addressing issues relating to middle-income and other countries not included in the category of heavily indebted poor countries.

* The present note has benefited from consultations with staff of the major institutional stakeholders in the financing for development process and other relevant agencies of the United Nations system. Responsibility for the contents of the note, however, rests solely with the United Nations Secretariat. The note was submitted for processing on 8 April 2004, due to the fact that the specific issues on which the Economic and Social Council would focus the meeting had not been selected before the middle of March 2004.

04-30537 (E) 220404

I. Introduction

1. Many of the concerns highlighted at the special high-level meeting of the Economic and Social Council with the Bretton Woods institutions and the World Trade Organization in April 2003 are still present today, in 2004, although to differing degrees of intensity. The global economic outlook has improved, despite the dampening effect on confidence of recurring threats to global peace and security. An acceleration of growth in all regions of the world is expected in the current year.[1] On the economic front, the challenge could be considered to be three-fold: (a) to maintain the growth and development momentum while ensuring that all countries, in particular low-income countries, grow at a satisfactory pace; (b) to unwind global imbalances in a way that does not cause serious disruption in either developed or developing countries; and (c) to ensure rapid implementation of the domestic and international actions agreed to in the Monterrey Consensus, adopted at the International Conference on Financing for Development in 2002, in order to achieve sustained development worldwide. In fact, at key multilateral forums in the last 12 months, the international community has emphasized the political will that is required for the rapid implementation of the "leading actions" agreed to in the Consensus.

2. The Monterrey Consensus embodies the main orientations for domestic and international policies and institutional reforms required for long-term and equitable development. A coherent implementation of the Consensus is critical to promote both mobilization of domestic resources and net financial transfers to developing countries, to increase productive investments and to enhance social programmes. The note by the Secretary-General for last year's special high-level meeting (E/2003/50) identified eight areas in which enhanced coherence among the key leading actions of the Monterrey Consensus was essential to improved outcomes: (a) a shared vision of development by national and international authorities at country and regional levels; (b) national efforts complemented by international efforts; (c) increased international financial flows accompanied by enhanced and more predictable access for exports; (d) enhanced market access for exports accompanied by the development of domestic production capacities; (e) increased private flows accompanied by measures that make the flows more stable than in the past; (f) volume and effectiveness of official development assistance (ODA) to be enhanced simultaneously; (g) design of national and international policies, including debt restructuring, taking full account of possible long-term as well as short-term consequences; and (h) improved and more democratic governance at the national level complemented by strengthened and democratic governance at the international level.

3. Today, two years after the International Conference on Financing for Development strengthening support for development efforts at both national and global levels remains a key task of the international community. Developing countries have made significant efforts in the main areas outlined in the leading actions of the Monterrey Consensus, including "Mobilizing domestic financial resources for development".[2] Recent multilateral assessments show an improved trend in developing country policies, particularly in four major areas: economic management, including macroeconomic and structural policies; measures and programmes for human resources development and social inclusion; policies for environmental sustainability; and enhanced public management and institutional

development for improved governance.[3] While not every country has made sufficient progress, and while in a few countries efforts have been scant or the lack of political will or special interests have prevented required reforms, evidence is strong that in many developing countries positive steps have been taken in the direction agreed to in the Consensus.

4. The complementary efforts by industrial countries have generally been uneven, as reflected in the following sections of the present note. Official development assistance (ODA), on the whole, has increased and progress has been achieved towards better donor coordination. Nevertheless, a large gap remains before the estimated levels required to achieve the Millennium Development Goals in 2015 can be attained. On the multilateral trade front, after the setback at the fifth Ministerial Conference of the World Trade Organization, held at Cancún, Mexico, from 10 to 14 September 2003.[4] The negotiations under the Doha Work Programme have resumed in 2004. As discussed later, a coherent approach to sustained development and poverty reduction requires simultaneous advances in public and private financial resource availability and access to trade.

5. Strengthened cooperation and coordination efforts are also required for improved global governance. A smooth unwinding of global imbalances requires coherent macroeconomic policies among major industrial economies. Lack of coherence can lead to outcomes that are in fact worse for those countries, as well as for developing countries. Insufficient cooperation and coordination could also lead to a sudden loss of confidence of main economic agents, an escalation in real interest rates and increased volatility of exchange rates among reserve currencies. Not only would international trade and growth dynamics be affected adversely, but global financial instability would also increase, with negative effects on development. Thus, it is critical that the major industrial economies, in formulating policy, take into account the eventual consequences of their decisions on all countries, including developing countries.[5] In the summary of the special high-level meeting of 14 April 2003, the President of the Economic and Social Council underlined that strengthened participation of developing countries in decision-making processes on economic policies, particularly in the international financial institutions, was an issue of central concern (see A/58/77-E/2003/62). Later, in October 2003, in his summary of the High-level Dialogue on Financing for Development, the President of the General Assembly presented the main views of the participants regarding steps to improve global economic governance, including greater use of the United Nations (A/58/555, para. 39).

6. The concerns set out in the above paragraph have led the members of the Group of Eight to widen their consultations on some of the issues on its agenda with a selected number of developing countries. Within the Bretton Woods institutions, the issue of voice and participation of developing countries has become part of the agenda for the deliberations of the Executive Boards, the International Monetary and Financial Committee and the Development Committee of the International Monetary Fund (IMF). The subjects under discussion cover measures to enhance the voice and to achieve more effective participation of developing countries and countries with economies in transition in the work and decision-making in IMF and the World Bank. In this regard, the aforementioned committees, at their meetings in Dubai in September 2003, decided to continue efforts on these issues. The Boards of Executive Directors were asked to report on all aspects of the issue of giving voice to developing countries at the 2004 annual meetings. The Development Committee

also agreed to consider a road map on procedures and next steps at its 2004 spring meeting.[6]

7. What follows is an analysis and review of the three themes chosen for discussion in the round tables at the meeting on 26 April 2004. Since areas (a) and (h) of the eight areas requiring enhanced coherence, identified in paragraph 2 above, have been covered in the Introduction, the remaining six will be considered jointly with the corresponding subjects addressed in more detail in the following three sections.

II. Theme 1: Impact of private investment and trade-related issues on financing for development

Investment climate and sustained economic growth, including the role of the private sector

8. Domestic resources were recognized in the Monterrey Consensus as the main source of financing for development in developing countries and countries with economies in transition. In this regard, sound fiscal management, judicious use of public resources and policies that facilitate domestic savings and the mobilization of private investment by promoting entrepreneurship and the development of the private sector are critical in economic and employment growth and poverty reduction. The importance of this linkage was stressed at the High-level Dialogue on Financing for Development[7] and underscored by the Commission on the Private Sector and Development in its recent report to the Secretary-General.[8]

9. The experience of developing countries indicates that for economic growth to benefit the entire population, the development of small and medium-sized enterprises is a fundamental component of private sector growth. At the same time, continued efforts are needed to implement employment and social policies that support poverty eradication, enhanced social protection, gender equality and fair income distribution. To that end, coherence and coordination in economic and social development policies, as embodied in national development strategies, is essential.

10. National efforts have been made in a significant number of countries in different areas of institutional reform aimed at creating an enabling environment for domestic as well as foreign private investment, but these efforts need to be sustained and enhanced.[9] Measures to improve governance include: increased transparency and accountability; strengthened anti-corruption legislation and implementation; measures to combat money-laundering and tax evasion; rule of law; an impartial judiciary; well-defined property rights; and effective regulatory systems. Enhancing official oversight of corporate governance and adherence to accounting and auditing standards protect both investor rights and the public interest and are integral to strengthening the functioning of the private sector. Widening and solidifying national participatory decision-making processes contribute to mobilizing broad-based domestic political support for enabling policies and fostering a strong democratic and inclusive policy-making system. In addition, continued progress in ending conflict and building peace and security is essential for providing a supportive environment for private investment.

11. Institutional reform is a long-term process, dealing with a wide-range of policy areas. Past experience suggests that, in order to achieve results, developing and transition economies may need to prioritize and sequence their reform policies, as developed countries have done, based on their capacity, specific circumstances and goals.

12. The adoption of the United Nations Convention against Corruption in December 2003, which provides a new set of standards and measures to promote international cooperation and, inter alia, recognizes the importance of repatriating national assets lost through corruption, is an example of recent efforts in international and regional cooperation to improve governance. The peer review mechanism on economic and political governance within the New Partnership for Africa's Development was made operational in February 2004; the challenge is to achieve more broad-based participation, in addition to the current 16 participating countries in this mechanism, to maximize its effectiveness.

13. Experience in both developed and developing countries underscores the importance of sustained economic growth and stability to private investment. While significant progress has been made in improving macroeconomic stability in countries with developing and transition economies in the last decade, they continue to remain vulnerable to shocks from the global economy. To mitigate the effects of external shocks, and to promote stability in economic growth and social and infrastructure expenditure over the economic cycle, the need for these countries to implement macroeconomic policies based on a medium term time frame that enables them to use counter-cyclical macroeconomic policies is increasingly recognized. This promotes the coherence between short-term and long-term policies to foster sustained economic growth. But further effort is needed in many countries in macroeconomic policy reform, public debt management, reform in the tax code and administration and the formulation and implementation of medium-term fiscal frameworks for public expenditures. For their part, major industrialized countries have an important role to play in improving policy coherence and coordination to promote global economic growth and stability. In this regard, they must consider the impact of their policies on developing countries, as discussed above.

14. An enabling environment for investment and private sector development are also supported by the strengthening of physical infrastructure, including information and communication technologies (ICT) and the development of human resources. In many countries, these expenditures have declined in the recent global economic downturn or following specific financial crises. Therefore, the above-mentioned fiscal management reform and the mobilization of additional investment in these areas are urgently needed.

15. In addition, the importance of a sound and effective financial system to the development process is well proven. There is growing recognition that inclusive financial systems that are accessible to small and medium-sized enterprises, microenterprises, the rural population, women and the poor are conducive to broad-based private productive activities. Many countries have continued their efforts in financial regulatory reform to strengthen this sector. Further assessment and reform of the regulatory system and financial policies with a view to reducing barriers to financing for many segments of the population will contribute to building an inclusive system. The crucial role that commercial and specialized financial institutions, including development banks, housing banks, credit unions, pension

funds and insurance companies, can play in financial sector development and private sector development in all countries, within an appropriate regulatory, prudential and supervisory framework, must be kept in mind.

16. Development experience indicates that a system of fair and transparent rules on competition among firms and on taxation and reduced barriers to the establishment of new firms, in particular small and medium-sized enterprises, foster the development of the private sector. A reassessment of the regulatory and tax systems of developing and transition countries aimed at "levelling the playing field" can greatly improve the investment climate. Facilitating the development of ancillary business services can complement these efforts by supporting the operations of small and medium-sized enterprises and improving their access to financing.

17. At the same time, coherent and coordinated support from developed countries and multilateral organizations is critical to the policy efforts of countries with developing and transition economies. Financial and technical assistance in capacity-building in the relevant policy areas in these countries provide critical support for domestic policy reform and implementation. One good basis for further efforts in this area is the poverty reduction strategy paper process. In addition, increased export access to developed country markets improves prospects for growth of the private sector. Promotion of technology and skills transfer from industrialized countries through investment and trade is of high importance for the development of a diversified and technologically dynamic private sector. Moreover, experience in the last decades suggests that more streamlined conditionalities of multilateral organizations and other donors, multilateral agreements fully supportive of national development strategies and more flexibility for counter-cyclical national macroeconomic policies are also needed.[10] Donor flexibility in this regard may be necessary for low income countries.

Questions

18. **What more can be done to stimulate increased public and private savings in developing countries? What approaches can be used to address the increasing needs of public expenditures in education, health and infrastructure while increasing private investment in productive sectors? How can national development strategies and poverty reduction strategy papers focus more attention on the Millennium Development Goals and on the coherence of macroeconomic policies and general development policies? Should there be more space for expanding multilateral lending in a counter-cyclical context? How can multilateral agreements in trade, finance and other areas ensure that developing countries have adequate policy space to improve technology and skills, enhance the dynamism of their private sector and accelerate economic growth?**

External private capital flows, including foreign direct investment

19. The Monterrey Consensus emphasizes the vital complementary role of private international capital flows, particularly foreign direct investment, in financing for development. The importance of national and international efforts to increase these

flows to countries with developing and transition economies while reducing their volatility and enhancing their development impact was reaffirmed at the High-level Dialogue on Financing for Development and by the General Assembly in its fifty-eighth session.[11]

20. Private capital flows to developing countries have declined sharply since the late 1990s. Although they have shown signs of some recovery during the past year, they remain considerably below average levels registered during the first half of the 1990s. Short-term capital flows have been volatile and pro-cyclical. Foreign direct investment (FDI) has been essentially the only source of net private inflows to these countries since the Asian financial crisis. After declining strongly in 2002, FDI in developing countries stabilized and is expected to rebound in 2004, although it remains very low or negligible in many developing countries.

21. National policies that create an enabling environment for domestic private investment are also conducive to international private capital flows. The aforementioned national policies in this regard have yielded results in improving the investment climate in countries with developing and transition economies, although sustained efforts are essential. There have been increasing efforts in information collection and dissemination by both the public and private sectors aimed at improving the quality and availability of relevant information for investors, which can significantly contribute to reducing risk. In addition, bilateral investment treaties, which have an important role to play in reducing political and legal risks involved in investing in these countries, have grown steadily and embody more comprehensive obligations that can have more far-reaching impact. Bilateral double taxation treaties have also increased and are important instruments in helping to reduce undue tax burdens on investors while allocating taxes between home and host country governments. Both types of treaties can enhance the attractiveness of a host country to foreign investors if complemented by favourable economic and institutional conditions.

22. As discussed above, the macroeconomic policies of major industrialized countries have a direct effect on global economic growth and stability and on capital flows to countries with developing and transition economies. International measures, including cooperation and partnerships involving donor and recipient countries, the private sector and multilateral organizations, are also important in promoting investment flows. The Cotonou Agreement between the European Community and its member States and the members of the African, Caribbean and Pacific Group of States sets out a comprehensive set of home country measures, detailing provisions related to investment promotion, investment finance and support and investment guarantees. International financial institutions and developed countries have mechanisms for mitigating the risk of investing in developing and transition economies, including the provision of officially supported export credits, arrangement of risk guarantees and funding of feasibility studies, which have been effective, to varying degrees, in helping to promote external capital flows to these countries. A review of these measures, with a view to shedding light on the relative effectiveness of different measures, could help to identify areas of greater emphasis and innovative approaches.[12]

23. Regional and bilateral arrangements promoting integration in trade and financial cooperation have been found to help attract external capital flows. Such arrangements have increased substantially in the last several years, and it is

important that they be coherent with multilateral agreements. As some middle-income countries have become significant international investors, these agreements can help to expand their potential as important sources of foreign direct investment in developing and transition economies. Furthermore, international support, through financial and technical assistance, for regional development initiatives, such as the New Partnership for Africa's Development and other regional efforts, can also help to bolster external capital flows to developing regions.

24. In addition to increasing FDI flows to developing economies, there is general agreement that it is also important to ensure that the resulting development benefits are maximized. In his report on the implementation of the Monterrey Consensus (A/58/216), the Secretary-General stressed that national policies should provide incentives to FDI that maximizes technology transfer and improves the domestic value added of exports, in particular the creation of new jobs. Efforts have been made by some home country Governments in this connection, but continued efforts are needed. Further analysis of existing and additional proactive measures in home and host countries would help to identify coherent and effective measures in this regard, taking into account, inter alia, their budget costs. With the growing number and scope of the above-mentioned investment and double taxation treaties, parties to these agreements can also pay greater attention to their development dimensions. Moreover, consultations between international or regional financial organizations, Governments and the private sector in both home and host countries have been used to exchange views on policies and private sector expectation. This mechanism can be used more intensively to help attract private capital flows to developing countries and strengthen their development impact.

25. Remittances from workers to their home countries, which have increased substantially in the last few years, becoming the second largest source of financial inflow to developing countries after FDI, are nearly 40 per cent greater than all official development assistance (ODA). They are also more evenly distributed among recipient countries than private capital flows, more stable and may possibly be counter-cyclical. Recognizing the importance of remittances as a source of finance, developing countries, at the Doha negotiations, have raised the priority they place on the issue of temporary movement of natural persons (mode 4 in the definition of services trade and modes of supply of the World Trade Organization) to supply services (see para. 32 below). As remittances provide resources for consumption as well as investment in small and medium-sized enterprises or microenterprises, increasing efforts have been made in developing countries and in cooperation with developed countries to reduce the cost of remittances and to channel funds to development-oriented investments. International agreements on facilitating legal, long-term migration can also enhance the flow of remittances to developing countries.

Questions

26. **How can the provision of information for potential investors in developing countries be strengthened? How should the official sector better mitigate the risks facing private investors in developing countries? What additional measures can be undertaken in home and host countries to attract FDI that will enhance technology transfer, spill over to domestic industry and improve the domestic value added of exports? How effective have public/private**

partnerships been as a mechanism for the provision of investment in developing economies? Many business associations, civil society and other entities and stakeholder groups have proposed corporate social responsibility guidelines to address the role of domestic and foreign enterprises in contributing to attaining development, social and environmental objectives. Should the diverse approach of these codes of conduct or principles be integrated into a coherent set of guidelines and standards? How can international cooperation in finance and trade be made coherent in promoting worker remittances to spur investment?

Trade-related issues

27. The Monterrey Consensus recognizes the potential of international trade as an engine for development and that, in order to harness this potential, it is imperative to achieve a multilateral agreement on trade liberalization that benefits all countries, taking into account the needs and interests of developing countries. The Doha work programme includes, inter alia, negotiations on agriculture, services, market access for non-agricultural products, trade-related aspects of intellectual property rights, World Trade Organization rules, a set of development-related issues, in particular special and differential treatment, and implementation issues and concerns. Importantly, it was agreed to seek to place the needs and interests of developing countries at the heart of the work programme. In agriculture, for example, members committed themselves to comprehensive negotiations aimed at substantial improvements in market access, reduction of, with a view to phasing out, all forms of export subsidies and substantial reduction of trade-distorting domestic support. The Doha negotiations, therefore, present a challenge to developed countries to implement trade policies that are coherent with development policies by increasing market access for developing country exports to complement their need for increased capital inflows.

28. After the impasse in the negotiations on the Doha agenda at the fifth Ministerial Conference of the World Trade Organization in Cancún in September 2003, there was an agreement on the urgent need for the negotiations to be resumed. Accordingly, the negotiating bodies on agriculture and market access for non-agricultural products met in March 2004 and other negotiating bodies have also commenced work. On agriculture and market access for non-agricultural products there are suggestions that frameworks be established by mid-2004 to facilitate further detailed efforts at advancing the negotiations and the promotion of modalities for commitments. There is recognition that restoring the stalled Doha round and bringing about its successful conclusion requires exertion of political will, good faith, cooperation and compromise by all parties. The processes and decision-making framework also need to be inclusive, transparent and democratic. At Cancún, the developing countries demanded that their views be taken into consideration in the negotiation process, as reflected in the formation of issue-based alliances, including the Group of 20 and the Asian, Caribbean and Pacific States/African Union/least developed countries group. In this regard, the marginalization of the least developed countries, landlocked countries and small economies, including small island developing States, in world trade underscores the importance of addressing their particular needs.

29. There is a widespread view that agriculture negotiations need to progress before negotiations on market access for manufactured goods and services and other

issues can move ahead. To enhance benefits of development, trade agreements need to be consistent with the capacities and development objectives of developing countries and provide for special and differential treatment as mandated in the Doha Declaration. The European Union's offer to eliminate subsidies on products of interest to developing countries and the recent United States proposal to eliminate agricultural export subsidies by a certain date and substantially decrease and harmonize levels of trade-distorting domestic support offer prospects for progress in this area.

30. Many developing countries, including the least developed countries, depend heavily on a few commodities that are subject to large fluctuations in demand, as well as to decline in long-term prices. This places importance on addressing the issue of commodities, including the Cotton Initiative of some African countries.[13] Because of the volatility of world markets, efforts have been made to assist developing countries in the use of risk management, financial instruments and export diversification programmes to mitigate shortfalls in export earnings, and these efforts should be continued. However, there is still no adequate solution to the problem in sight and relevant international commodity-related counter-cyclical financing facilities are also lacking.[14]

31. Most developing countries have indicated they are not yet convinced of the potential gains to them from the World Trade Organization disciplines on the "Singapore issues", which could give rise to significant implementation costs and would divert resources and political attention away from more important issues. The willingness of the European Union to remove competition and investment from negotiations and the recent United States suggestion to focus negotiations only on trade facilitation open a new avenue for consultations.

32. Securing increased participation of developing countries in international trade in services is becoming increasingly important from both a development and a trade perspective. The potential contribution of temporary movement of natural persons (mode 4) in the services agreement to supply services has been identified by developing countries as crucial to the expansion of their export earnings and to poverty reduction. This suggests that constraints on the temporary movement of service suppliers need to be addressed in the negotiations through a specific commercially meaningful commitment. Outsourcing of services through cross-border mode of supply (mode 1 in the definition of services trade and modes of supply of the World Trade Organization) is an increasingly important area of interest to developing countries.

33. The challenge for developing countries remains how to integrate into the world economy on terms coherent with their development priorities. Central to this is the need to identify development strategies and national policies that enhance their capacity to benefit from trade liberalization and increased market access. The Trade Integration Mechanism proposed by IMF and the strengthening of its capacity to provide support to countries experiencing exogenous shocks are aimed at facilitating this process. In addition, the implementation of trade liberalization involves considerable adjustment, which entails short-term economic and social costs for all countries. Therefore, in developing countries, proper sequencing of commitments and synergy of national policies, including those aimed at diversification of exports into higher value added products and increasing competitiveness, need to be supported by adequate financial and technical assistance to build capacity and social

safety nets. The Integrated Framework for Trade-Related Technical Assistance to least developed countries and the Joint Integrated Technical Assistance Programme launched by the International Trade Centre, UNCTAD and the World Trade Organization are examples of such support. International technical assistance in institutional and capacity-building appropriate for other developing countries is also needed.

34. Almost all members of the World Trade Organization currently participate in or are actively negotiating regional or bilateral trade agreements, and the pace has accelerated since the launch of the Doha negotiations. Such efforts can be beneficial in terms of trade liberalization and development when they are coherent with the multilateral trading system. Therefore, many countries and multilateral authorities have underscored the importance that these agreements be building blocks, and not stumbling blocks, to a fully multilateral trading system.

Questions

35. **How can the forthcoming negotiations of the World Trade Organization and the eleventh session of UNCTAD contribute to a successful conclusion of the Doha development agenda? How can the trade policy reviews of the World Trade Organization contribute to enhancing the coherence of member policies with domestic and global development objectives, including those contained in the Monterrey Consensus, and attaining the Millennium Development Goals? Given the vulnerability of many developing countries to volatility in international trade and financial flows, what combination of increased official balance of payments financing and specific trade measures could mitigate instability in these countries? Should international financial mechanisms used to mitigate the temporary financial distress of low-income commodity-dependent countries during cyclical downturns be reconsidered? How can the coherence of bilateral and regional trading arrangements with the multilateral system be ensured?**

III. Theme 2: Role of multilateral institutions in reaching the Millennium Development Goals

Monitoring the Millennium Development Goals

36. Monitoring progress towards the Millennium Development Goals has received increased attention in the past two years, with greater emphasis being given to the mutual responsibilities and accountability involved in achieving the Goals. Since the adoption of the Millennium Declaration, the Monterrey Consensus and the Johannesburg Programme of Implementation, the international community has established defined responsibilities for reporting on progress towards the Millennium Development Goals. For his part, the Secretary-General is required to report annually to the General Assembly on the implementation of the Millennium Declaration, including global and regional progress towards achievement of the Goals.[15] In order to fulfil this responsibility, 48 well-defined and accepted indicators were established to monitor progress. Data pertaining to each indicator are collected by the specialized agency or organization concerned. Such data conform to the

international standards established by the agency or organization, to a common regional classification and, where available, to a common base year of 1990. This framework of targets and indicators was accepted by the General Assembly and serves as the basis for a Millennium Indicator Database, which is maintained by the Statistics Division of the Department of Economic and Social Affairs.[16] A summary of these data, showing, wherever possible, each indicator by region and for the base and latest year, is contained in the annexes to the reports of the Secretary-General referred to above.

37. For their part, the World Bank and IMF, with the assistance of other agencies, are monitoring progress in implementing the national and international policies and actions deemed necessary for the achievement of the Millennium Development Goals. This assessment of progress in policy will be reflected in an annual *Global Monitoring Report*, to be produced each spring. The first such report will be considered by the Development Committee in April 2004, immediately prior to the meeting of the Economic and Social Council.

38. There has also been a major effort to conduct similar work on the Millennium Development Goals at the country level, primarily through the preparation of reports by interested countries with developing and transition economies. This work has been supported by the United Nations Development Programme (UNDP) and the United Nations country teams and financed through the Millennium Trust Fund. As of the end of January 2004, 58 reports[17] covering 51 countries had been prepared and another 32 reports were expected in the first quarter of 2004. Of the 51 countries, 18 are least developed countries and 7 are low-income countries, but the reporting effort is now more concentrated on the more disadvantaged countries. Reporting at the country level has proven to be a useful tool for raising public awareness of trends, disparities and progress towards the Goals and, by involving the participation of all stakeholders, for helping Governments to translate the Millennium Development Goals into national priorities and locally relevant visions.[18]

39. As a result of the increased data-collection effort, it has become apparent that there are gaps in the international statistical system in some relevant areas and that, even where data and data standards are well-defined, there is inadequate statistical capacity in many developing countries and countries with economies in transition to collect and assemble the necessary data. The monitoring has also served to underline the interrelationship and interdependency between the goals and the actions necessary to achieve them as well as between the various data being assembled for monitoring purposes. The adoption of the Millennium Development Goals has therefore brought increased international attention to overcoming statistical weaknesses at both the national and international levels and improved statistical cooperation within national Governments and among the multitude of international agencies involved in monitoring progress towards the achievement of the Goals.

40. Recognizing the need for statistical capacity-building and improved statistical literacy in developing countries, based on wider coverage of data, improved accessibility to information and strengthened skills in data analysis, a global action plan proposed by the World Bank was agreed at the second International Roundtable on Managing for Development results, held in Marrakesh, Morocco, on 4 and 5 February 2004. The plan recommends six sets of actions aimed at achieving tangible and sustainable improvements in national and international statistical capacity.[19] The

annual incremental cost of implementing these actions has been estimated at $115 to 120 million for national statistical systems, with an additional $24 to 28 million a year required to improve the international system. The plan also notes that external financing is necessary for many poor countries.

41. The Monterrey Consensus recognized that stronger actions by developing countries must be supported by developed countries in a global development partnership if the Millennium Development Goals are to be achieved. However, in contrast with the results to be achieved by the developing countries, there is no time frame for the targets set for the developed countries and, apart from the global monitoring being undertaken under the leadership of the United Nations, little monitoring of progress in developed countries. To fill this vacuum, developed countries have begun to issue reports assessing their own national efforts to fulfil their commitments in relation to Millennium Development Goal 8. The first report, issued by Denmark, assesses a wide range of areas, including the quantity and quality of aid, harmonization of aid (in the context of the Rome Declaration on Harmonization of February 2003), agricultural subsidies, debt relief and access of developing countries to modern technologies.[20] A number of other developed countries are considering the issuance of similar reports.

Questions

42. **How may the Millennium Development Goals country reports be used to promote deeper understanding of the long-term benefits of development and poverty reduction policies by the general public in both developed and developing countries? How can current international and national efforts in assessing coherence and harmonization of developed country policies be coordinated to strengthen monitoring and assessment of their efforts to fulfil their commitments to Goal 8? Since education of women is critical to long-term development and a significant number of countries are lagging in attainment of the Millennium Development Goals in education, what more can be done at the national and international levels to accelerate progress? How can multilateral institutions enhance coordination and cooperation in their statistical capacity-building efforts to maximize their effectiveness and contribute to overall capacity-building in decision-making in key policy areas in developing countries and transition economies?**

Poverty reduction strategy papers and other development tools

43. A shared vision of development by national and international authorities at the country and regional levels is key to coherent policy formulation and international cooperation efforts. While there has been a significant convergence of views on several of the principal elements, objectives and policy directions that constitute the desired development strategy, there has also been an increasing recognition of the importance of effective ownership and of the fact that countries with different structural conditions can take diverse yet still successful approaches to achieving sustained development. In low-income countries, where the main policy objective is poverty reduction, the poverty reduction strategy papers have become a key strategic and implementation vehicle to reach the Millennium Development Goals.

44. Translating the Millennium Development Goal targets into action requires an operational framework at the national level. For the poorest developing countries, the poverty reduction strategy papers play a critical role in bringing together national policies and international support for their efforts towards achieving the Goals. While there is greater recognition of the importance of country specificity and diversity in development priorities, more and more poverty reduction strategy papers try to focus on the achievement of the Goals. In addition, international financial institutions and other multilateral development organizations increasingly use the strategy papers as a decision-making tool, including being increasingly taken into account in the formulation of the United Nations country assessments and development assistance frameworks and influencing the design of the World Bank's country assistance strategies and decisions relating to the provision of development assistance and debt relief from multilateral and bilateral institutions.

45. An increasing number of developing countries have begun to prepare and implement poverty reduction strategy papers (as of end-January 2004, out of the 35 countries which had completed and were implementing strategy papers and the 18 countries which had prepared interim papers, 30 were from Africa). The strategy papers are gradually reflecting broader country ownership, as evidenced by the involvement of a wider array of stakeholders and stronger focus on national policies towards the achievement of the Millennium Development Goals and economic growth.

46. Notwithstanding these gains, challenges remain in the preparation of poverty reduction strategy papers. Continued attention is needed on integrating the poverty reduction strategy paper process with existing decision-making processes, particularly the budget, and expanding the involvement of sectoral ministries and representative bodies such as parliaments. The links of country strategies to the Millennium Development Goals should be deepened and the financial, policy and institutional constraints to the achievement of medium-term development goals need to be addressed. Furthermore, the pace of progress in aligning donor support with country strategies has to be accelerated. In particular, enhancing country ownership involves fully incorporating country development priorities in poverty reduction strategy papers, including the prioritization of the main objectives in the papers. In addition, supporting capacity-building, such as in data collection and analysis, is needed to enable the preparation of truly country-driven strategies.

47. The United Nations common country assessment is the instrument used by the United Nations system to analyse the national development situation and identify key development issues, while focusing them on the achievement of the Millennium Development Goals. The United Nations Development Assistance Framework (UNDAF) is the common strategic framework for the operational activities of the United Nations system at the country level. It provides an integrated, coherent response to national priorities and needs within the framework of the Development Goals and other commitments. The common country assessment and UNDAF have been mainly responsible in assisting developing countries in capacity-building activities, including help in the preparation of the poverty reduction strategy papers and Millennium Development Goal reports.[21] At present, there is not yet enough evaluation activity at the country level by the United Nations system as a whole. Steps are being taken to increase such activity.[22]

48. Parallel to the United Nations common country assessment is the World Bank's country assistance strategy. The strategy is central vehicle for the Bank's Board of Executive Directors to review assistance strategy for borrowers of the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA) in order to maximize impact on poverty reduction. Since the country assistance strategy provides the framework for the World Bank's involvement in a country, the international community welcomes the increasing involvement of stakeholders in its preparation and urges their further alignment with the country's national strategy. Eventually, multilateral donors hope to shift the aid paradigm to provide all assistance in the form of budget support for a comprehensive, country-owned development strategy. The poverty reduction strategy paper process, the High-level Forum on Aid Harmonization in Rome and the second roundtable on development results in Marrakesh converge around this ultimate objective.

49. The New Partnership for Africa's Development, a strategic framework for addressing the challenges confronting African countries, including endemic poverty and bringing countries on a path of sustainable growth and development, prioritizes the development issues of the region. The peer review mechanism within the New Partnership, discussed earlier, aims to monitor country performance in the field of economic management, human rights, corruption and democracy in the context of attaining the Development Goals. The recognized need within the New Partnership for a strengthened framework of partnership between Africa and its development partners has led to the establishment of the African Forum for Envisioning Africa, which will focus on strategic and political issues related to the implementation of the programme of action of the New Partnership. The Forum has identified four priorities for action: peace and security; HIV/AIDS; education; and economic growth and wealth creation; all leading to the achievement of the Millennium Development Goals.

50. The Tokyo International Conference on African Development, a multilateral initiative focused on promoting sustainable economic growth and reducing poverty in Africa, held its third conference in Tokyo in September-October 2003, at which it called on the international community to support Africa's development in a spirit of partnership.[23] In the tenth anniversary declaration, adopted at the conference, participants declared that the ultimate goal of the conference was to promote ownership by African countries of their development processes and partnership with the international community in the implementation of their national strategies for development.

Questions

51. **How can the assessments and experiences of the various multilateral development institutions be more effectively shared and used in improving the formulation and implementation of existing development instruments? What can be done to further integrate the Millennium Development Goals and the objectives of the poverty reduction strategy papers into the national policy priorities, as reflected in the budget? How can each donor's development cooperation tools, such as UNDAF, and the country assistance strategy, be effectively aligned with the recipient country's national development strategy? Since recent studies indicate that excessive use of conditionalities remains**

counterproductive for both donors and recipient countries, what efforts can be made by all donors to coordinate and streamline conditionalities? How can the international community strengthen recipient initiatives such as the New Partnership for Africa's Development, and thus help developing countries meet their agreements reached in Monterrey?

Financing the Millennium Development Goals, including new and innovative sources

52. As pointed out in last year's note (E/2003/50), increased coherence in achieving the Monterrey Consensus objectives requires that both the volume and effectiveness of ODA be enhanced simultaneously. The outcome of the High-level Forum on Harmonization, held in Rome on 24 and 25 February 2003, led to the creation of the OECD Development Assistance Committee Working Party on Aid Effectiveness and Donor Practices to, inter alia, facilitate the harmonization and alignment of donor practices with country strategies. Various national action plans on harmonization have been given a boost as a result of the High-level Forum. These issues were also the focus of the second International Roundtable on Managing for Development Results in Marrakesh in February 2004, which was convened by the five major multilateral development banks in collaboration with the Development Assistance Committee. The Roundtable agreed on a set of core principles governing development partners in their development cooperation programmes. Aid effectiveness is also being addressed at the regional level. The European Commission, for instance, recently put forward proposals aimed at expediting progress on the pledge made at the European Union Barcelona Summit in March 2002 to achieve closer coordination of policies and harmonization of aid procedures.[24] The Economic Commission for Africa is engaged in a joint effort with the Development Assistance Committee in creating an institutional framework for mutual accountability between Africa and its partners. An important function of this alliance is to conduct joint African/OECD reviews of the impact of partner country policies on Africa's development cooperation programmes.[25]

53. As selectivity is increased in the provision of aid, based on the recipient country's commitment to sound policies, the special needs of countries in or emerging from conflict need to be taken into account. To address the needs of especially vulnerable countries, the World Bank established the Post Conflict Fund in 1997 to support the transition of countries from conflict, and the Trust Fund for Low Income Countries Under Stress to, inter alia, help poor countries ineligible for IDA funds to strengthen their institutions and build capacity for the delivery of social services. For these groups of countries, timely, adequate and predictable assistance is critical to remove institutional capacity limitations and to facilitate the rebuilding effort. Moreover, aid selectivity could improve if it is complemented by an examination of the overall aid and trade policies of donor countries in order to ascertain that they are not inimical to the interests of the developing countries.

54. After many years of decline, ODA levels are rising. As several major donors began to deliver on their Monterrey pledges, ODA reached $58 billion in 2002, and is projected to rise to $77 billion in 2006, a 32 per cent rise in real terms based on pledges made by donors.[26] The share of ODA to Gross National Income (GNI) is forecast to rise from 0.23 per cent to 0.29 per cent during the same period. However, it is widely agreed that attainment of the Millennium Development Goals will

require inter alia, a more substantial increase in international resource flows to developing countries, estimated, at a minimum, to be in the order of a doubling of present levels of ODA flows. Also, particularly for many of the poorer countries where the challenge is most acute, most, if not all, of these flows will have to be on a grant or very highly concessional basis. In this regard, it is important that the provision of assistance for peace and security purposes, such as the war on terrorism and the rebuilding efforts in war-affected zones, does not crowd out regular development aid.

55. As indicated above, while some individual countries may substantially increase their ODA over the next several years, circumstances do not augur well for reaching the total volume deemed necessary in the medium and longer term. Many developed countries already face severe fiscal constraints and additional demands are likely to increase these pressures over the longer term. The task is, therefore, not only to mobilize resources to meet the immediate need to accelerate progress towards the attainment of the Millennium Development Goals, but also to formulate a strategy that will ensure the predictable and necessary flow of resources over the long-term. In this connection, it should be recalled that, even if the Goals were to be universally attained by the target date, they would reflect only partial achievement of the overall development task. Poverty may be reduced by half, but it will remain a global challenge; success in the other areas will also be far from complete, and a sustained flow of financial resources will continue to be required in this context.

56. Recognizing this, there has been increased analysis and discussion in various arenas, including within a number of Governments and regional bodies, of a wide variety of possible new ways and means of increasing the supply of international financial resources for development. Debate and study of an international finance facility proposed by the United Kingdom is ongoing. Other ideas range from some that are completely new to others that have a long vintage and from those that focus on mobilizing additional public resources to those aimed at obtaining support from the private sector, including individuals. The most recent initiatives include a special fund jointly proposed by the Governments of France and Brazil aimed at mobilizing financing through innovative means, including selective forms of taxation, to help reduce hunger and poverty.

57. The General Assembly, having discussed innovative sources of finance on various occasions in the past, contributed to increasing the debate on this matter when, as a result of the five-year review of the World Summit for Social Development, it adopted resolution S-24/2, calling for "a rigorous analysis of the advantages, disadvantages and other implications of proposals for developing new and innovative sources of funding, both public and private, for dedication to social development and poverty eradication programmes". Paragraph 44 of the Monterrey Consensus also calls for the consideration of possible innovative sources of finance in the appropriate forums. The Secretariat subsequently commissioned the World Institute for Development Economics Research (WIDER) to undertake this study, which is now nearing completion. At its fifty-eighth session, the General Assembly called for the study to be presented to its fifty-ninth session.

58. Few of the specific proposals under discussion have been subjected to intergovernmental debate. However, bearing in mind the need for additional financial resources for development and the additional analytical material becoming available, it would be opportune to initiate such debate with a sense of urgency since

most of the proposals, even if they found acceptance, would take several years to become reality. The fifty-ninth session of the General Assembly would be a starting point for discussion, but these matters could also be pursued, as appropriate, within the Bretton Woods institutions and in future meetings between the Economic and Social Council and the institutions.

59. In this context, it should also be mentioned that there have recently been important proposals by groups of middle income countries, including the Rio Group initiative aimed at examining the urgent adoption of "flexible and innovative financial mechanisms" to facilitate increased public and private investments.[27] Most middle income countries have set priorities for policies and investments that are aimed at poverty reduction by helping poor people contribute to, and benefit from, economic growth. Social spending has been increased and has become better targeted. Nevertheless, poverty has risen in a number of these countries owing to disappointingly low economic growth and persistent inequality. There is, therefore, widespread agreement that it is imperative to explore what should be done at the national and international levels to achieve sustained economic growth and poverty eradication in such countries.

60. Because of their vulnerability to volatile capital flows, middle income countries also need special international support to meet the Millennium Development Goals, in particular, effective financing mechanisms that can be activated quickly to help protect poverty reduction expenditures and maintain ongoing reforms in the event of external shock or major changes in a country's condition. In May 2002, the World Bank introduced its "deferred drawdown option", to protect core structural programmes should a country face reduced access to international financial markets. Several countries have already arranged deferred drawdown option facilities.

Questions

61. **How can multilateral and bilateral development policies ensure that official assistance for the most vulnerable countries is sustained to help them work towards attaining the Millennium Development Goals as selectivity in aid provision is increased as a means to enhance effectiveness? How can the international community ensure that reconstruction and rebuilding relief is additional to regular development assistance? How can bilateral and multilateral donors balance the need for enhancing aid effectiveness with helping low-income countries under stress to meet the Millennium Development Goals? How can multilateral organizations facilitate the international debate and expedite progress on the formulation and implementation of new and innovative sources of financing? How can existing financing mechanisms for low-income countries be adapted or new mechanisms formulated to meet the needs of middle-income countries?**

IV. Theme 3: Debt sustainability and debt relief

62. The Monterrey Consensus recognizes external borrowing as an important source of financing that can help developing countries grow faster and counter the impact of economic shocks. However, excessive accumulation of debt could bring

about just the opposite results. This concerns both countries with emerging economies and low-income countries. The international community has thus sought to strengthen its understanding of debt sustainability and the policies and measures that would help borrowing countries service their debts during difficult periods without an unrealistically large contraction in national income and expenditure. This reflects the sentiment expressed in the Monterrey Consensus when it called for bearing in mind the impact on progress towards achievement of the development goals contained in the Millennium Declaration in future reviews of debt sustainability.

Heavily Indebted Poor Countries Initiative

63. The Heavily Indebted Poor Countries Initiative has been criticized as being slow in bringing countries to their "decision points" and then to their "completion points". As of March 2004, and almost five years after the Initiative was enhanced, only 27 heavily indebted poor countries out of the 38 countries potentially eligible for assistance under the Initiative have reached a "decision point" and are receiving debt relief. Of the 27 countries, 10 have reached "completion point", the point at which full debt relief has been accorded.[3]

64. The delays in reaching the "decision point" have been attributed to problems in preparing the poverty reduction strategy papers and meeting fiscal targets and in the evaluations of international financial institutions of the success of the heavily indebted poor countries in establishing a track record of implementing sound economic policies. Reaching this phase has been especially challenging for countries in conflict or emerging from conflict. With the Heavily Indebted Poor Countries Initiative set to expire by the end of 2004, there is concern that some countries may not benefit from the programme. In this regard, options concerning extension of the date of expiration of the Initiative are being studied and the staff of both the World Bank and IMF will present their recommendations to their respective Boards by September 2004.

65. It has been evident that, despite reaching "completion point", some countries have not achieved debt sustainability. It is also generally accepted that the inability of these countries to achieve debt sustainability results from unrealistic assumptions that went into the calculation of how much relief the countries needed in order to reach a sustainable debt level, including interest rates, export volumes and economic growth. In some cases, there have been problems in policy implementation.

66. The need for additional debt relief beyond the Heavily Indebted Poor Countries Initiative was reaffirmed by some creditor governments in October 2003, at the United Nations High-level Dialogue on Financing for Development, when they agreed to revisit the issue of "topping up", a mechanism to provide additional debt relief to heavily indebted poor countries that continue to have unsustainable debt situations. Participants at the dialogue noted, however, that these proposals were only part of the solution and that, for many low-income countries, maintaining debt sustainability required significantly increased financial assistance in the form of grants.

67. Grant finance, which was on the decline in the 1990s, seems to be on the rebound.[3] The thirteenth replenishment of IDA (IDA13 programme) provided for a much larger share of assistance in the form of grants to eligible countries and

initiatives such as the new Global Fund to Fight AIDS, Tuberculosis and Malaria. The international community should ensure that the trend of increasing provision of grant assistance continues.[28]

68. It has also been suggested that the Heavily Indebted Poor Countries Initiative should include a wider framework of measures to overcome external and natural disaster shocks, including rapidly available contingency financing by the international financial institutions, based on annual reassessments of debt sustainability and policy adequacy.[29]

69. Looking beyond the Heavily Indebted Poor Countries Initiative process, IMF is finalizing an analytical framework for assessing debt sustainability in low-income countries. For this group of countries, separate guidelines are deemed necessary because their debt is mainly official. Its purpose is different — to guide lending decisions of bilateral official donors and multilateral institutions as well as to provide policy advice to the borrowing countries.

Questions

70. **Are debt-servicing obligations hindering the ability of many developing countries to meet the Millennium Development Goals? Should growth-oriented policies in the development strategies of heavily indebted poor countries and other low-income countries receive greater emphasis in the context of debt sustainability? What are the main difficulties in establishing a framework for assessing debt sustainability of low-income countries? Is the donor community ready to provide adequate additional debt relief to those low-income countries that are unable to achieve debt sustainability upon exiting from the Heavily Indebted Poor Countries Initiative programme?**

Middle-income developing countries

71. In 2002, IMF introduced a new analytical framework for assessing both fiscal and external debt sustainability in countries with significant access to international financial markets.[30] This framework is now being applied in the context of surveillance and use of IMF resources. It can also guide debtors and creditors in their discussions on how much debt reduction is required in order to reach a manageable pattern of repayments over time. It does not take explicit account of the social impact of debt servicing, although this could be addressed in a parallel public expenditure review.

72. The identification of the debt levels at which difficulties may emerge in any particular country is an extremely difficult exercise. Many countries with emerging economies got into serious trouble at levels of debt indicators that were equivalent or even significantly lower than those in many developed countries. One of the major reasons for that seems to be the much greater volatility of debt service relative to the capacity to pay in developing countries. But it is also likely that traditional indicators of debt sustainability do not fully capture all the factors that have a bearing on debt-servicing capacity, such as the type of expenditure that is financed by external borrowing and the trade structure of a country. It, therefore, appears necessary to assess all relevant factors in individual countries and to establish a

closer link between debt management, fiscal and macroeconomic policies and development strategies.

73. Unlike developed countries, most countries with emerging market economies cannot borrow abroad in their own currencies, irrespective of quality of policies or strength of institutions.[31] Therefore, movements in the exchange rate can seriously affect the domestic burden of debt service. It may be that this factor is a much more important source of uncertainty than the volatility associated with fluctuations in income. In addition, interest rates on emerging market debt are not only much higher, but are also subject to large fluctuations as markets change their assessments of the riskiness of a country's debt. The debt burden of developing countries can thus rise suddenly and sharply. This can occur even if a country's macroeconomic policies are sound.

74. Along with further improvement of sustainability analysis, it is important that the international community assists debtor countries in better monitoring their evolving debt-servicing obligations and managing their payments during volatile periods. This entails prudent debt management, sound reserves policy and access to international liquidity. Many developing countries, with the support of the international community, are working on building capacity in sovereign debt management. Technical and financial assistance in this area is being provided by various international institutions, including UNCTAD, IMF, the World Bank and the Commonwealth Secretariat.[32]

75. There is also a need for international precautionary financing facilities capable of providing prompt and sufficient financial support for countries that face potential financial crises. The contingent credit line, introduced by IMF in 1999, was intended to achieve this objective. However, the facility was never used and expired in November 2003. IMF is exploring other ways to achieve the same objectives. It is vital that any new facility or instrument have the capacity to respond quickly to financial needs of member countries that have sound policies but are nevertheless challenged by the actions of the globally integrated capital markets.

76. With regard to the extreme volatility of debt service, there have been proposals to issue debt instruments whose debt service obligations fluctuate with the capacity of countries to pay, including GDP-indexed bonds.[33] There is also some interest in exploring financing arrangements that include guarantee schemes and other mechanisms to reduce the cost of debt during crisis periods. Another proposal to modify debt contracts is the promotion by the international community of internationally traded local-currency debt obligations of developing countries.

77. A more long-term strategy is to foster the development of domestic currency bond markets. The development of these markets has the potential to reduce the exposure of countries with emerging economies to maturity and exchange rate mismatches and to the risks of any sudden halt in access to foreign capital markets. In some cases, enhanced regional cooperation may accelerate the development of bond markets by combining relatively small national markets into a deeper regional one.

78. Along with preventive measures, it is necessary to have an agreed international strategy for dealing with the unsustainable debts of low-income and middle-income countries that are not classified as heavily indebted poor countries. The policy intention here has been to insert more clarity and certainty in the process for

resolving unsustainable debt situations. Over the past several years, there has been a vigorous and constructive debate on ways to address this problem. The debate has been instrumental in developing a better understanding of the issues involved and advancing work in a number of areas to improve restructuring arrangements. In particular, significant progress has been made in the design and use of collective action clauses in bond contracts.[34]

79. Since collective action clauses address only one aspect of debt, efforts are also under way to improve the overall process of sovereign debt restructuring in the event of a debt crisis, with particular emphasis on how to strengthen the exchange of information between a government debtor and its creditors and to ensure comparability in the treatment of different creditors and overall adequacy of relief when the restructuring involves a large and diverse group of creditors. In one approach, discussions have begun between a number of emerging market countries and representatives of the private sector on a voluntary code of conduct, which would broadly stipulate the roles that key parties would be expected to play in resolving a debt crisis. At its meeting in October 2003, the finance ministers and central bank governors of the Group of Twenty encouraged issuers and market participants to engage in further discussions of the issue, with the members of the Group participating on a voluntary basis.[35]

80. In this regard, the Paris Club of government creditors has agreed to reform its practices. In October 2003, representatives of the creditor countries agreed on a new approach to deal with countries in debt difficulties that are not covered by the Heavily Indebted Poor Countries Initiative, as requested by the Finance Ministers of the Group of Eight at their meeting in May 2003. According to this approach, the Paris Club will, in exceptional circumstances, break from its traditional practice of applying standard terms for particular classes of debtor governments in order to better tailor its response to the specific financial situation of the country in crisis with the aim of achieving lasting debt sustainability. The new approach also calls for better coordination between the Paris Club and private creditors to assure comparability of treatment of their respective claims.[36]

81. The efforts by IMF to develop a statutory approach, including the Sovereign Debt Restructuring Mechanism proposal, to the comprehensive treatment of the debt of a country in crisis did not win enough support to advance further. Most debtor governments and their private creditors were not satisfied with the proposal. The IMF International Monetary and Financial Committee, as well as the participants in the High-level Dialogue on Financing for Development, signalling that much remained to be done, emphasized the importance of further work on issues of general relevance to the orderly resolution of financial crises.[37]

82. In December 2003, in its resolution 58/230, the General Assembly encouraged the formation of multi-stakeholder dialogues on policy matters related to the implementation of the Monterrey Consensus. The exploration in such an informal forum of main unresolved debt policy issues may help identify proposals that could gain political support, build momentum towards consensus and facilitate their implementation in the appropriate forums.

Questions

83. **Has the new framework for assessing debt sustainability in countries with emerging economies been able to better inform policy decisions in a better fashion? What are the major unresolved issues? What are the prospects for developing precautionary financial mechanisms to achieve the objectives of the contingency credit line initiative of IMF? What other debt policy instruments and financing mechanisms should be promoted? What are the major remaining gaps in the international sovereign debt restructuring framework? How should these gaps be addressed?**

Notes

[1] See *World Economic Situation and Prospects 2004* (United Nations publication, Sales No. E.04.II.C.2). Forecasts made after 11 March 2004 still envisage gross domestic product (GDP) growth in all regions to be significantly above 2003 growth figures.

[2] See *Report of the International Conference on Financing for Development, Monterrey, Mexico, 18-22 March 2003* (United Nations publication, Sales No. E.02.II.A.7), chap. I, resolution 1, annex, paras. 10-19; see also A/58/216.

[3] See World Bank and International Monetary Fund, *Global Monitoring Report 2004: Policies and Actions for Achieving the MDGs*, part II, Developing Country Policies. Also, regarding the investment climate, see UNCTAD, *World Investment Report 2003: FDI Policies for Development: National and International Perspectives* (United Nations publication, Sales No. E.03.II.D.8).

[4] For an assessment of the outcome of the fifth Ministerial Conference, see TD/B/50/8.

[5] Partly in recognition of this, the Organisation for Economic Cooperation and Development (OECD) has been working on a "horizontal project" on policy cooperation for development, which looks at the impact of a broad range of developed country policies on developing countries, and is also paying increasing attention to issues of policy coherence in its Development Assistance Committee (DAC) peer reviews.

[6] It is noteworthy that, in respect to the question of voice and participation of developing countries in the Bretton Woods institutions, the Consultative Meeting of African Governors of the Bretton Woods institutions met in Johannesburg, South Africa, on 12 March 2004, to address such issues. In their communiqué of the meeting, they presented proposals in key related areas: quota formulae, basic votes, voting power in the International Development Association and the number of chairs representing sub-Saharan Africa.

[7] A/58/555.

[8] See United Nations Development Programme, *Unleashing Entrepreneurship: Making Business Work for the Poor*, report of the Commission on the Private Sector and Development to the Secretary-General of the United Nations, 1 March 2004, chap. I.

[9] See the World Bank and the International Monetary Fund, *Global Monitoring Report 2004*, part II, Developing Country Policies.

[10] For a discussion of counter-cyclical macroeconomic policies, see A/58/216, paras. 15-22. Such policies should be consistent with, inter alia, the appropriate fiscal and debt sustainability criteria.

[11] See General Assembly resolution 58/202.

[12] This aspect was amply covered at the informal meetings with the business sector, held on 24 March 2004, and in a related business sector workshop on mobilizing private sector investment in developing countries, held on 23 March 2004.

[13] At a World Trade Organization workshop, convened in March 2004 in Benin, on the development aspects of the Cotton Initiative, follow-up actions in delivery mechanisms for cotton-specific financial and technical assistance were agreed upon.

[14] Recommendations to address the commodity issue were made by the Eminent Persons Group Meeting on Commodity Issues convened by UNCTAD (see TD/B/50/11) and also featured prominently in the Financing for Development Hearings with Civil Society, held on 22 March 2004.

[15] The two reports to date are A/57/270 and A/58/323.

[16] See http://unstats.un.org/unsd/mi/mi_goals.asp.

[17] Five countries have produced two reports and one country has published its third consecutive annual report.

[18] On the relationship between the Millennium Development Goals and the poverty reduction strategy papers, see the United Nations Development Group and the World Bank, "How do the Millennium Development Goals relate to the poverty reduction strategy paper", April 2003.

[19] For detail, visit http://www.managingfordevelopmentresults.org/2ndRoundtable.html.

[20] Ministry of Foreign Affairs, Denmark, "2015: Denmark's first reporting on Goal 8", 2003.

[21] As of January 2003, 44 least developed countries (LDCs), 31 landlocked developing countries and 14 small island developing States have completed common country assessments; 36 least developed countries, 19 landlocked developing countries and 14 small island developing States have completed UNDAF. For more information, see www.un.org/special-rep/ohrlls/ohrlls/cca_undaf_prsp.htm.

[22] See E/2003/64. Further study of the issue is expected to continue in the context of the 2004 triennial comprehensive policy review and its expected follow-up, and should rely on collaboration with the Inter-Agency Working Group on Evaluation.

[23] For more information on the Tokyo International Conference on African Development, see www.ticad.net.

[24] See Commission of the European Communities, "Communication from the Commission to the Council and the European Parliament: translating the Monterrey Consensus into practice: the contribution by the European Union", 5 March 2004, Brussels (COM (2004) 150).

[25] Concerns about the poor prospects of many sub-Saharan countries in attaining the Millennium Development Goals have also resulted in a Commission for Africa launched by the United Kingdom. Its aim is to advance internationally agreed development goals in the region. The high-level commission, in collaboration with the United Nations, the World Bank and the academic community, building on the work of the New Partnership for Africa's Development, will assess conditions and development policies in African countries in priority areas, including trade, governance, economic policy, aid, debt relief, health and environment and conflict resolution.

[26] The European Union report states that member States are firmly on schedule to reach or even exceed their target to collectively increase their average ODA from 0.33 per cent of GNI to 0.39 per cent of GNI in 2006. It is estimated that European Union ODA will increase every year to equal 0.42 per cent of its GNI by 2006. See also "Commission acts to boost efficiency of EU development aid through better coordination and harmonization" (COM (2004) 150). At the International Conference on Financing for Development, the United States also pledged to raise ODA by $5 billion a year by 2006, a 50 per cent increase in core development assistance, through the establishment of the Millennium Challenge Account (MCA). In January 2004, Congress signed into law the Millennium Challenge Corporation (MCC), and in February an interim chief executive officer was agreed by the MCC Board. In May, the Board will meet to select the countries eligible for MCA assistance.

[27] See seventeenth Summit of the Rio Group, Cusco Consensus, Cusco, Peru, 23-24 May 2003, and thirteenth Iberoamerican Summit, Santa Cruz de la Sierra, Bolivia, 13-15 November 2003.

[28] Some quarters in the international community have expressed concern over the proliferation of such specialized vertical funds, including the potential for such funds to undermine the implementation of a balanced sector-wide approach, as well as the concern that these funds are less conducive to realizing cross-sectoral synergies than the more horizontal funding approaches.

[29] See A/58/290, para. 30.

[30] "IMF Discusses Assessments of Sustainability", Public Information Notice (PIN) No. 02/69, 11 July 2002.

[31] For a discussion of this phenomenon see, for instance, Barry Eichengreen, Ricardo Hausmann and Ugo Panizza, "Currency mismatches, debt intolerance and original sin: why they are not the same and why it matters", National Bureau of Economic Research Working Paper No. 10036, October 2003.

[32] For more details, see A/58/290, para. 39.

[33] See, for instance, Morris Goldstein, "Debt Sustainability, Brazil, and the IMF", Working Paper No. WP 03-1, Institute for International Economics, February 2003.

[34] For a discussion of collective action clauses, see *World Economic and Social Survey 2003* (United Nations publication, Sales No. E.03.II.C.1).

[35] "Morelia Communiqué", fifth meeting of Finance Ministers and Central Bank Governors of the Group of 20, Morelia, Mexico, 26-27 October 2003.

[36] For a more detailed description of the new approach, see *World Economic Situation and Prospects 2004* (United Nations publication, Sales No. E.04.II.C.2).

[37] See A/58/555, paras. 32-35.

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I. Introduction

1. Pursuant to Economic and Social Council decision 2003/313, the eleventh meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters was held at Geneva from 15 to 19 December 2003.

2. In its resolutions 1980/13 and 1982/45, the Council defined the terms of reference of the Group of Experts as including, inter alia, the formulation of guidelines for international cooperation to combat tax evasion and avoidance and the study of possibilities for enhancing the efficiency of tax administrations and reducing potential conflicts among tax laws of various countries. With the significant growth of international trade and investment, tax authorities in developing countries and economies in transition face increasing challenges in assessing and collecting the taxes due to them from international transactions. The Group of Experts provides advisory services for strengthening the administrative and technical capacities of the tax administrations in developing countries and countries with economies in transition through the organization of interregional workshops on international taxation and through technical cooperation and assistance.

3. For over three decades, the United Nations has demonstrated its commitment to international tax cooperation through its support for the Group of Experts. In the report of the Secretary-General on implementation of and follow-up to commitments and agreements made at the International Conference on Financing for Development,[1] it was recommended that the Group of Experts be converted into an intergovernmental body, either in the form of a committee of governmental experts or of a special new commission, as a subsidiary body of the Economic and Social Council. The General Assembly subsequently adopted resolution 58/230, in which the Assembly requested the Economic and Social Council, in its examination of the report of the Group of Experts at its next substantive session, to give consideration to the institutional framework for international cooperation in tax matters.

4. The eleventh meeting of the Group of Experts was attended by 23 tax experts, a record-number of 68 observers and various consultants and staff. The United Nations Secretariat prepared the basic documentation for the meeting and organized a meeting of the Steering Committee of the Group of Experts in New York in May 2003 to review the work of the Group of Experts on transfer pricing, new financial instruments, tax of electronic commerce, mutual assistance in tax collection, the possible upgrading of the Group of Experts in light of the implementation of the Monterrey Consensus, the revision of the United Nations Model Double Taxation Convention between Developed and Developing Countries and the *Manual for the Negotiation of Tax Treaties between Developed and Developing Countries*. The Committee also reviewed arrangements for the twelfth meeting and formulated recommendations on the issues to be discussed at that meeting.

5. The following members of the Group of Experts attended the eleventh meeting: Mr. Antonio Hugo Figueroa (Argentina), Mr. Kenneth Allen (Australia), Ms. Luciana Mesquita Sabino de Freitas Cussi (Brazil), Mr. Liao Tizhong (China), Mr. Abdoulaye Camara (Côte d'Ivoire), Mr. Mahmoud Mohammed Ali (Egypt), Mr. Pascal Saint-Amans (France), Mr. Wolfgang K. A. Lasars (Germany), Mr. John Evans Atta Mills (Ghana), Mr. Panna Lal Singh (India), Mr. Surjotamtomo Soedirdjo (Indonesia), Mr. Mayer Gabay (Israel), Mr. Errol Hudson (Jamaica),

Mr. Armando Lara Yaffar (Mexico), Mr. Noureddine Bensouda (Morocco), Mr. Joseph A. Arogundade (Nigeria), Mr. Riaz Ahmad Malik (Pakistan), Mr. Babou Ngom (Senegal), Mr. Keith Engel (South Africa), Mr. José Antonio Bustos (Spain), Mr. Daniel Luthi (Switzerland), Mr. Andrew J. Dawson (United Kingdom of Great Britain and Northern Ireland) and Ms. Patricia A. Brown (United States of America).

6. The meeting was also attended by observers from: Azerbaijan, Bahamas, Barbados, Belgium, Cameroon, Cayman Islands, Chile, the Congo, Cuba, the Czech Republic, Egypt, Iran (Islamic Republic of), Ireland, Israel, Italy, Kenya, Malaysia, Morocco, Nicaragua, Nigeria, Norway, Romania, the Russian Federation, Rwanda, Singapore, Slovakia, South Africa, Spain, Thailand, Tunisia, Uganda, Ukraine, Venezuela and Viet Nam.

7. The meeting was also attended by observers from the following international bodies and other institutions: the Commonwealth Secretariat; the Organization for Economic Cooperation and Development (OECD); Fairleigh Dickinson University; the International Association of University Presidents; California State University, Sacramento; the Catholic University of Louvain; London Metropolitan University; World Association of Former United Nations Interns and Fellows; the Tax Justice Network; the Associaçao Comercial de Sao Paulo, Sheltons, International Tax Counsel; Shacham Tax Law Office; Adachi, Henderson, Miyatake and Fujita; International Chamber of Commerce, Paris and KPMG International.

8. The Secretariat provided support to the Group of Experts and was assisted by the following advisers and resource persons drawn from different areas of international taxation: Professor Michael J. McIntyre (Wayne State University Law School), Professor Francisco Alfredo Garcia Prats (University of Valencia), Mr. Jon E. Bischel (tax attorney) and Mr. David E. Spencer (tax attorney). The Group of Experts elected Antonio Hugo Figueroa (Argentina) as Chairman and Mayer Gabay (Israel) as rapporteur. Mr. Abdel Hamid Bouab served as Secretary and was assisted by Mr. Masakatsu Ohyama (Assistant Secretary).

9. The agenda for the eleventh meeting was as follows:

1. Mutual assistance in collection of debts and protocol for the mutual assistance procedure.
2. Treaty shopping and treaty abuses.
3. Interaction of tax, trade and investment.
4. Financial taxation and equity market development.
5. Transfer pricing:
   (a) Simplified safe harbour procedures;
   (b) Intermediation and arbitration: European Union experience.
6. Tax treatment of cross-border interest income and capital flight: recent developments.
7. Electronic commerce and developing countries.
8. Revision and update of the United Nations Model Double Taxation Convention between Developed and Developing Countries.

9. Revision and update of the *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries*.

10. Institutional framework for strengthening international tax cooperation.

The discussion of the main items on the agenda is summarized below.

II. Mutual assistance in the collection of tax debts and protocol for mutual assistance procedures

10. The Group of Experts reviewed the existing United Nations, OECD and European Union agreements and mechanisms for mutual assistance in tax matters. The central question raised was whether a provision similar to article 27 of the OECD Model Convention, dealing with assistance in collection, should be included in the United Nations Model Tax Convention.

11. The Group of Experts noted that, traditionally, mutual assistance in tax matters has been provided for in the exchange of information article (article 26) in income tax treaties. The fundamental issue in any tax system is the collection of taxes. It is natural, therefore, to consider cooperation on collection.

12. During the discussion, a question arose as to whether mutual assistance should be limited only to taxes covered by the convention or should extend to all taxes of the contracting states, including local taxes and social security. One approach would be to postpone requests for collection assistance until all internal remedies have been exhausted. In any event, requests for collection must be accompanied by the proper paperwork. Precautionary measures, such as seizures, must not interfere with normal business conduct. It might be desirable to allow assistance in collection on a voluntary basis before a full exhaustion of remedies, when the administrative costs of assistance are small and the costs of exhausting remedies are large.

13. It was suggested that assistance in the collection of taxes might be limited solely to taxes covered by a tax convention or might be extended to other taxes. Whether a country should agree to a broad assistance-in-collection provision would depend in part on its capacity to provide assistance.

14. It was noted that some countries may have serious constitutional problems in collecting foreign tax debts. Therefore, the proposed addition of article 27 to the United Nations Model Convention must clearly establish what sorts of debts can be collected. In many cases, domestic laws must be changed to permit the collection of foreign tax debts. Other members suggested that constitutional issues generally be covered during the treaty negotiations.

15. The Group of Experts established a focus group (Belgium, Chile, France and Morocco) at the meeting to prepare a recommendation with respect to the adoption of an assistance-in-collection article. The focus group prepared some draft language for the Model Convention and for the Commentary. It was decided that the members of the Group of Experts should exchange views on the draft, with the expectation that the matter would be taken up at the next meeting of the Group of Experts.

III. Treaty shopping and treaty abuses

16. Many significant international developments have occurred since the topic of treaty abuses and treaty shopping were last addressed by the Group of Experts.

17. Three main questions were addressed in the meeting. First, what is considered a treaty abuse? In that connection, it is necessary to decide who is to determine the existence of an abuse. Second, how are the standards for dealing with treaty abuse being established? In that connection, the standards for determining an abuse might be included in the treaty itself. Third, is it acceptable to deal with treaty abuse with domestic anti-abuse mechanisms? In that connection, it may be necessary to take account of the legal nature of treaties and the obligations derived from the public International Law of Treaties.

18. Representatives noted that although a precise definition of the term "treaty abuse" is not available, there is a broad recognition that treaty abuses exist and must be dealt with. The impossibility of reaching a common definition of a treaty abuse was partly due to the mechanisms for dealing with tax treaty abuse. Persons covered by a tax treaty are its ultimate beneficiaries, despite the fact that a treaty is signed by contracting States and is intended to advance the interests of the contracting States.

19. The existence of a treaty abuse implies an indirect violation of the law, contrary to its goal and objectives. Such a violation can only be determined after taking into account the specific circumstances of a particular case. In general, a treaty abuse is determined by national authorities under their domestic law and according to their legal tradition. For this reason, the concept of a treaty abuse is likely to vary from State to State. The question of treaty abuse is often a question of who are the bona fide beneficiaries of the treaty.

20. Normally, the term treaty abuse is used to refer to situations in which the taxpayer is seeking to circumvent the law. But consideration should also be given to cases in which one of the contracting States takes advantage of the good faith of the other contracting State to the Treaty by making a future amendment to its laws or by administrative practices that lead to significant losses of resources of the other contracting State. The two situations, abuse by the taxpayer and abuse by the contracting State, should be distinguished in the framing of the rules used to determine the existence of the abuse, in identifying the bodies that would declare the existence of an abuse and in establishing the legal consequences of identifying an abuse.

21. Treaty abuse and treaty shopping should not be confused. Treaty shopping relates to situations in which an individual benefits from a treaty without being the legitimate beneficiary of it. Treaty abuse, on the contrary, refers to situations in which the result of a certain operation is in contradiction with the treaty. Whenever the treaty shopping issue is considered important, it should be addressed specifically in the treaty, including countervailing measures to combat it. Nevertheless, in certain treaty shopping situations, general measures countervailing abuse could be used even in the absence of a specific provision in the treaty.

22. It was noted that a real need exists for new tools to deal with treaty shopping, taking into consideration the willingness of some States to promote it. In that

respect, countries should look carefully into the practices of those States before entering into a treaty with them.

23. OECD has attempted to deal with treaty abuses through amendments to the commentary to article 1 of its Model Tax Convention on Income and on Capital (OECD Model Convention). A proposal on the update of the commentaries on article 1 of the United Nations Model Tax Convention between Developed and Developing Countries (the United Nations Model Convention) was presented at the meeting. The proposal assumed that any update of the Commentary on article 1 of the United Nations Model Convention should take into account, as a point of departure, the update carried on by the OECD in 2003 to the Commentary on article 1 of the OECD Model Convention. Nevertheless, it was stressed that it was impossible to automatically assume and translate all the amendments made by OECD to its Model Convention, since there had been little discussion on certain issues at the United Nations meeting. The Group of Experts adopted the view that the discussion of changes to the Commentary should continue and should be taken up at the next meeting of the Group of Experts.

24. The general consensus was that the amendment of the Commentary on article 1 of the United Nations Model Convention deserved further attention and that a final decision should not be made until the next meeting of the Group of Experts. It was decided that the process of discussing the different approaches would continue so as to promote a consensus on the substantive amendments to the Commentary prior to the next meeting of the Group of Experts.

25. **On the basis of the discussion, it was recommended by the Group of Experts that the question of whether the United Nations should recommend an article in the Model Convention on the limitation of benefits that would be responsive to the needs of developing countries should be discussed. In particular, many developing countries have difficulty negotiating treaties with some developed countries because the major taxpayers in those countries are able to get the benefits of a treaty by using the treaty negotiated with another country.**

IV. Interaction of tax, trade and investment

26. Tax competition among developing countries can have harmful effects and is a major issue with regard to international tax cooperation. Tax competition and how to address it can be well understood by evaluating the interaction of tax, trade and investment, as embodied in the bilateral tax treaty network and the World Trade Organization.

27. The goal of free and fair trade cannot be achieved through tariff agreements alone because non-tariff policies such as quotas, preferential treatment and subsidies can also generate trade-restricting effects. Of special concern are direct and indirect tax structures, which can act as implicit production and export subsidies. Likewise, internal taxes should not discriminate between domestically produced and imported goods, especially when they are used in a particular sector, because such use produces a subsidy effect. Finally, taxation of income flows from foreign direct investment in both the source and the resident State can constitute a fiscal barrier to trade and capital flows. The resulting double taxation problems can be alleviated by bilateral tax treaties. These tax treaties should maintain an equitable distribution of

revenues between the two countries while being conducive to capital flows to developing countries.

28. A multinational enterprise may shift income to affiliates resident in a low-tax country in order to take advantage of the lower rates on manufacturing income in the source country or in order to avoid residence jurisdiction. Owing to their bilateral nature, tax treaties cannot deal effectively with harmful tax competition. What may be needed is a multilateral approach to the tax competition problem. The international community is however, not ready for a multilateral agreement on tax competition.

29. Developing countries have to compete for limited capital. This creates a dilemma for developing countries as the competition may cause them to offer overly generous tax concessions and, hence, rely on tax incentives that may not be in their best interest or that may not have the desired effect in attracting investment.

30. Developing countries that decide to employ tax incentives should try to select incentives that minimize their revenue cost and other harmful effects.

V. Financial taxation and development of equity markets

31. The effects of a country's tax structure on equity markets are uncertain. In principle, a country's tax structure can affect: (a) economic growth; (b) capital inflows; and (c) the development of equity markets. In addition, empirical research shows there is a linkage in all three areas. The research is limited in scope, in that there are numerous non-tax factors that affect economic growth and market development. In addition, it is not clear whether biases have been introduced, for example, by including only short-term effects or by failing to distinguish between harmful, beneficial and neutral tax concessions.

32. It was noted by many participants that tax is only one of the factors among others affecting development of capital markets. Therefore, tax incentives alone will not be effective for the development of capital markets. Other factors include the fiscal framework, transparency, good infrastructure, sustained economic growth and political stability. Tax treaties would also be important.

33. The United Nations Model Convention does not provide for tax on capital gains of non-residents, although it permits the taxation of dividend income. It was pointed out that the non-taxation of capital gains in the source country probably results in double non-taxation in many cases.

34. Taxation on capital gains and dividends are treated differently in the United Nations and OECD Model Conventions. In many important cases, dividends can be converted into capital gains quite easily. Conversion of dividends into capital gains is less of a problem for portfolio investment.

35. In practice, one could not equate the taxation of capital gains with that of dividends. To a large extent, the tax on capital gain is a "secondary" tax, imposed after the stock has been issued by its initial public offering. A tax on dividends, however, is a direct tax on corporate income being distributed to a shareholder. If the corporation does not pay a dividend, its income remains within the corporation. This distinction may be a valid basis for treating capital gains and dividends

differently, but only if dividends cannot be converted into capital gains, as occurs in many countries.

36. In summary, although taxes have an impact on equity markets, the observation alone is not helpful, because other factors play a role and all markets are not homogeneous. In some developing countries, generous tax incentives aiming at stimulating the stock exchange failed while in some countries such policies have worked. Moreover, markets at different stages of development cannot be compared. The tax factor may not be as important in one market as it would be in another when the market is growing rapidly. However, it was felt that, based on past experience, new tax policies for capital markets should not be introduced in times of fiscal crisis.

VI. Transfer pricing

A. Simplified safe harbour procedures

37. A safe harbour for setting transfer prices may operate in favour of the Government or the taxpayer. Unfortunately, no one seems to be able to develop effective safe harbour rules that are satisfactory to both. One approach would be to divide the profits from an enterprise through some type of formula, for example, using worldwide combined reporting with formulary apportionment. Several of the states of the United States have used such a method successfully, and the European Union is exploring the use of some type of apportionment method owing to the problems of applying a transactional-pricing method for companies operating within the European Union.

38. Transfer pricing is a worldwide problem. All countries have experienced difficulties in finding comparable transactions and comparable companies under the arm's length rule. Frustration with the practical aspects of the arm's length approach has led some countries to favour the use of a safe harbour method. A problem may arise in reconciling safe harbour rules with treaties because safe harbour rules may move away from the arm's length approach. Unfortunately, safe harbours are not a panacea. Although the arm's length system works reasonably well for sales of tangible property, when intangible property is being considered, the transfer pricing system is less successful, because intellectual property income is difficult to locate by source and is very hard to price. The consequence is a tendency to use the profit-split method when profits are generated in large part by intangible property.

39. A first step in dealing with transfer-pricing matters might be to get international agreement on accounting standards and on the types of accounting documents that the taxpayer would be required to divulge to the tax authorities of particular countries. The European Union has made major strides in developing uniform accounting standards over the past several years. With the development of uniform accounting standards, the problems of assessment could be reduced significantly if multinational enterprises were required to disclose their intergroup trading. Affiliated groups would be required to file unconsolidated accounts. Tax administrators could use this information to locate aberrations in the distribution of the profits of the multinational enterprises among affiliated companies.

40. One possible approach to dealing with transfer pricing problems, increasingly common in developed countries, is to adopt what OECD refers to as advanced pricing arrangements. Under the advanced pricing arrangement structure, multinational enterprises are invited to reach agreement with the tax office on their pricing methodologies for future transactions. Often an advanced pricing arrangement is negotiated with treaty partners as well through the mutual agreement procedure. To obtain an advanced pricing arrangement, the multinational enterprise must supply evidence of the arm's length price. The process tends to result in the development of a secret body of law, not subject to the usual public scrutiny. Many developing countries may not be able to administer an advanced pricing arrangement programme because they do not have the technical capacity to do so. Some developing countries may also be concerned about the possibility of corruption in the administration of such a programme.

41. Although the arm's length approach is supposed to result in realistic prices, it often falls short in reality. Rather than focusing on overly general rules, it may be more useful to address some specific areas of concern. For example, a country might develop different transfer-pricing rules for areas such as commodities, intangibles and value-added products. In at least some of these areas, progress might be possible. In many cases, what is needed is expertise. OECD has meetings of transfer pricing inspectors to develop issues that are further developed by the tax administrators in the Group of Experts.

B. Intermediation and arbitration: experience of the European Union

42. Various business groups, including the International Chamber of Commerce, have been promoting the inclusion of an arbitration provision in tax treaties. They contend that such a provision would provide assurance that tax disputes would be resolved in a timely fashion. An arbitration provision may be binding or discretionary. The business community has tended to favour binding arbitration, whereas many Governments have been unwilling to surrender their power to set tax rules to an outside authority. The experience within the European Union is that the arbitration provision of tax treaties is almost never invoked. The claim is made, nevertheless, that the existence of an arbitration provision tends to promote prompt settlements. No data were available to show whether settlements were being made more promptly as a result of an arbitration provision or whether the decisions made under the threat of arbitration were appropriate ones.

43. Many developed and developing countries are sceptical about the merits of including an arbitration provision in the United Nations Model Convention. It was suggested that the Group of Experts had more pressing matters to address. A concern was expressed that a developing country might be put at a disadvantage in an arbitration proceeding because its resources and expertise may be much less than those at the command of a developed country on the opposite side of an arbitration process. It was estimated that an arbitration event would cost €50,000, a very significant sum for the tax departments of many countries.

44. Arbitration might be an attractive option if it could be implemented at low cost and resulted in prompt and fair decisions. It would be undesirable if it imposed heavy costs or if the threat of arbitration resulted in hasty, ill-considered settlements. The proponents of arbitration have assumed that arbitrators would be

neutral and competent and that arbitrators could be supplied when a country did not have the resources to engage an arbitrator. Whether these assumptions are warranted is far from clear.

VII. Cross-border interest income and capital flight

45. Capital flight is a growing problem for many developing countries. Capital may flee to other developing countries or to developed countries and to both onshore and offshore financial centres. Although precise figures on the total amount of flight capital from developed and developing countries are unavailable, the amounts are very substantial, perhaps in the several trillions of dollars. The amount of capital flight from developing countries alone is not known. Some, but by no means all, capital flight reflects an attempt at tax evasion.

46. In recent years, efforts at controlling capital flight have focused on international tax cooperation and the exchange of tax information. Capital flight is promoted by bank secrecy regimes and by the tax-free treatment of interest on bank deposits in major financial centres. Governments in major financial centres, both onshore and offshore, argue that they cannot reduce capital flight by adopting tough measures because the capital currently coming to their country would go to a more accommodating country. As a result, it is widely believed that multilateral efforts are required to confront the problem of capital flight and any resulting tax evasion.

47. The European Union has taken some important steps against capital flight, including the promulgation of the directive 2003/48/EC on the taxation of savings. The directive has established the principle that cross-border interest payments within the European Union to individuals resident in the Union should be subject to taxation. The mechanism for such taxation is either: (a) the automatic exchange of information between countries of the European Union; or (b) a withholding tax in the country where the payer of the interest is located. The above-mentioned directive does not, however, apply to interest paid from European Union countries to residents of third countries. The directive will, therefore, have no direct impact on capital flight from residents of third countries into the European Union, especially capital flight into the financial centres of the Union.

48. A second significant development is the effort by OECD and its Fiscal Committee to limit the use of tax havens and to limit capital flight from OECD countries to those tax havens. In 1998, the OECD Committee on Fiscal Affairs issued a report, "Harmful Tax Competition: An Emerging Global Issue". The OECD followed up the 1998 report with additional reports on the subject as well as releasing its Model Agreement on Exchange of Information on Tax Matters. The immediate impact of the OECD proposals is to limit capital flight from OECD countries to low-tax countries and to limit tax evasion within the OECD. Those proposals do not, however, attempt to limit capital flight from third countries into OECD countries and financial centres.

VIII. Electronic commerce and developing countries

49. The existing norms of inter-jurisdictional revenue allocation may not be valid in the digital era. To promote tax neutrality, the United Nations may consider revising its Model Convention to allow fuller taxation in the source country of income derived from e-commerce.

50. The existing international tax rules make sharp distinctions between the tax treatment of income from capital, labour, property and services. Those distinctions are becoming increasingly less valid in the digitalized era. The advent of e-commerce has caused the traditional concept of a permanent establishment to break down. Tangible property can be sold over the Internet in much the same way that it is sold in a bricks-and-mortar store. In addition, the taxation of services becomes difficult because valuable and important services can be provided across the globe without physical contact with the place where the service is used. For example, technical support for computer equipment can be provided over the Internet.

51. To allow for effective taxation of income from e-commerce in the source state, article 7 (Business profits) of the United Nations Model Convention might be modified to permit the source country to impose withholding tax upon all payments to a non-resident e-supplier in general, or, at the taxpayer's election, upon payments to a non-resident e-supplier from a domestic business that can deduct the payment. In addition, article 7 might be modified to allow a source country to adopt formula apportionment if an e-supplier has a permanent establishment in that country or if the e-supplier has sales in that country in excess of a threshold amount.

52. Another approach to the new problems created by e-commerce would be to modify the permanent establishment concept only as it applies to e-commerce activities. One suggested rule would provide that income from e-commerce could be taxed in the market State if the gross income from e-commerce in a country exceeded a *de minimis* amount. A second suggested rule would treat royalties, service income and sales income as active business income, taxable under the rules of article 7, with the caveat that income from e-commerce would be taxable if it exceeded the *de minimis* amount referred to in the first suggested rule. A third proposed rule would employ some type of global profit-splitting formula to determine the amount of income from e-commerce that each country would be permitted to tax.

53. Various issues need to be addressed to tax income from e-commerce effectively. The list of issues include: (a) identifying the participants in an e-commerce transaction (or set of transactions); (b) identifying the location of the business; (c) securing documentation and proof of the transaction; (d) identifying the specific economic characteristics of the e-commerce business; and (e) collection of the taxes due.

54. Most electronic commerce currently is between businesses, not between businesses and their customers. Taxation of income from business to business e-commerce is much easier to accomplish than the taxation of income from business to customer. For example, it is difficult to tax income from digital services, such as providing access to information databases and income from the sale of intangible products, such as digital music and digital games. Thus far, projections of the extent of e-commerce have been inflated, especially with regard to business to customer e-commerce. The ease of establishing e-commerce operations in offshore locations

has also been exaggerated. There is little doubt, however, that e-commerce will continue to grow and that the taxation of income from e-commerce will eventually become an important issue in developing countries.

55. **The current permanent establishment definition has proved difficult for many developing countries, in particular the requirement of a "fixed" location when there is the use of multiple permanent establishments for related business activities. On the basis of the discussion it was recommended by the Group of Experts that the United Nations might want to examine whether its Model Convention should be modified in various ways to deal with the practical problems that have resulted from the current definition.**

IX. Revision of the United Nations Model Double Taxation Convention and the *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries*

56. At its 10th meeting, the Group of Experts decided that the *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries*, published in 1979, was a valuable tool for developing countries and transitional-economy countries and should be updated. A revised draft, which did not alter the basic organizational structure of the original manual, was presented to the Group of Experts at its eleventh meeting. A general consensus emerged, nevertheless, that the original structure of the manual is now obsolete and ought to be modified in some major ways.

57. The Group of Experts reiterated the need to proceed with periodic revisions and updates of the United Nations Model Double Taxation Convention. It emphasized the need for such an important exercise particularly in view of the dynamic character of taxation and the need for the United Nations to continue to play the lead in this arena. The Group of Experts therefore agreed that these revisions in both the articles and commentary should be made at least once every two years.

58. The original manual was published prior to the publication of the United Nations Model Tax Convention and commentary. As a result, that manual included material later included in the commentary. The original manual also included an extensive discussion of the history of tax treaties and the role played by the League of Nations and the United Nations in promoting model conventions. This material may no longer be appropriate for inclusion in the manual.

59. Major changes in the manual were suggested. The objective of the revised manual should be to provide treaty negotiators with practical guidance for negotiating tax treaties that served national interests. To make the manual more useful to negotiators, the following changes were suggested: (a) the addition of a glossary of international tax terms; (b) a clear statement of the date of the current revision; (c) the use of more examples to illustrate particular points, with the examples displayed in indented format to draw the reader's attention and to separate them from textual material; and (d) a simplification of the current introductory section.

60. It was suggested that the manual might be published on the Internet and might include embedded links (hyperlinks) to background material, tax treaties and other references. Actual case studies might be included as well. A discussion of some additional topics might be added to the manual, including a discussion of capital flight and various anti-avoidance legislation.

61. There was a consensus that the manual should be produced in a more practical and useful format.

62. **On the basis of discussions the Group of Experts recommended revising the United Nations Model Double Taxation Convention between Developed and Developing Countries, which would involve the revision of articles: article 1 (Persons covered), article 5 (Permanent establishment), article 26 (Exchange of information) and the insertion of a new article 27 (Assistance in collection of taxes). The Group of Experts also recommended that the reformulation of the *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries* should focus on producing a document for use as a glossary for reference in international taxation, the United Nations Model Convention, tax treaties, negotiations and training.**

X. Institutional framework for strengthening international tax cooperation

63. As indicated earlier, a major issue on the agenda of the Group of Experts was the recommendation made in the Secretary-General's report on follow-up to and implementation of the outcome of the International Conference on Financing for Development[1] for strengthening the institutional framework for international cooperation on tax matters by converting the Group of Experts into an intergovernmental body within the subsidiary machinery of the Economic and Social Council of the United Nations. This recommendation was made in the context of implementation of the call in the Monterrey Consensus to strengthen international tax cooperation in support of development, through enhanced dialogue among national tax authorities and greater coordination of the work of the relevant multilateral bodies and regional entities. Subsequently, in its resolution 58/230 on follow-up to and implementation of the outcome of the International Conference on Financing for Development, the General Assembly requested the Economic and Social Council, in its examination of the report of the Ad Hoc Group of Experts on International Cooperation in Tax Matters at its 2004 substantive session, to give consideration to the institutional framework for international cooperation in tax matters.

64. The Group of Experts considered issues related to the upgrading of the Ad Hoc Group of Experts on International Cooperation in Tax Matters into an intergovernmental body, either in the form of a committee of governmental experts or a special new commission, as a subsidiary body of the Economic and Social Council. The Group of Experts felt that the members of any such body should be drawn from developed, developing and transition economy countries, as was the case with the Group itself.

65. It was suggested that an upgraded body should have a small technical staff adequate to support its activities, which might be established through redeployment of existing staff within the United Nations. Such a staff might include tax professionals in the fields of tax policy, tax administration, international tax matters, accountancy, law and economics. Though the technical secretariat could act as a clearinghouse for tax materials of interest to Member States and could also organize workshops to provide technical assistance on international tax matters, it should not duplicate functions now performed by other international bodies.

66. The body might draw some inspiration from the Fiscal Committee of the League of Nations, which had operated effectively in drafting some early model tax conventions. The objective would be to give Member States an enhanced opportunity for cooperation in the establishment of universally accepted international tax norms, building on the work and experience of the Group of Experts.

67. Comments were made by a large number of members and observers, many expressing strong support for the proposal, some raising issues that needed to be further addressed or clarified, others expressing various reservations, and a few indicating a preference for maintaining the status quo. Support was strongest from representatives of developing countries, civil society, professional organizations and those with university affiliations, whereas reservations or concerns were expressed primarily, but not exclusively, by representatives of various developed countries. The opinion of representatives of regional and international organizations was mixed. There was, however, nearly universal support for the goal of strengthening the capacity of the United Nations to provide leadership and assistance on international cooperation in tax matters.

68. There was a consensus on the following points: (a) the work of the Group of Experts ought to be strengthened; (b) developing and transition economy countries ought to have an effective forum for expressing their views on international tax issues; (c) any new or revised institutional arrangement ought to build on the work of the current Group of Experts and cooperate with other international activities to enhance tax cooperation; (d) an upgraded forum should convene more regularly than once every two years; (e) any new institutional arrangement should have a sufficiently limited number of members so that it could operate effectively; (f) the membership should include representatives from developed, developing and transition economy countries; and (g) Governments should select highly-qualified tax officials as their representatives.

69. The following major points were made in support of the proposal: (a) the United Nations is the main international organization within which it is possible to set universal norms relating to international cooperation in tax matters, and an enhanced forum would give greater legitimacy to the proposals coming from it; (b) an upgraded status for a forum within the United Nations would give the forum a greater opportunity to respond promptly to the ever-changing international tax environment; (c) the forum would provide an avenue for promoting more open disclosure of "reconciliation" tax records, which show inter-company transfers, and disclosure of those records would greatly facilitate audits and encourage consistent and fair treatment of taxpayers across national boundaries; (d) an enhanced arrangement and secretariat support staff would make it feasible for the United Nations to contribute more effectively to international and regional tax initiatives

and activities; (e) the need for an enhanced body with universally-drawn representation to address issues of international cooperation in tax matters is obvious, and critical in a globalizing world, and is going to be established sooner or later. Consequently, the real choice is whether the Ad Hoc Group of Experts is to be a part of, and help in, this inevitable development.

70. The following main reservations or objections were made to the proposal of upgrading the status of the Group of Experts: (a) a revised institutional arrangement, with members serving as representatives of their Governments might not work as smoothly or effectively as the current arrangement if the change caused the forum to become more "political"; (b) the forum would become unwieldy if it were to include representation from all 191 Member States of the Organization, while if it were to have limited membership, countries not represented might not be willing to have other countries "decide" matters affecting their tax policies; (c) the Group could become more effective within its current institutional arrangement by concentrating its agenda on problems particular to developing countries; and (d) a new "bureaucracy" would not be desirable and the Group should make better use of its existing resources and seek to complement its work with other international tax cooperation initiatives.

71. A number of steps that could be taken towards building an effective, enhanced forum on international tax cooperation were suggested to address the above reservations and objections. For example, to ensure smooth and effective functioning, the forum could establish internal procedures minimizing formality and offering substantial opportunities for free expression, since experience shows that many international bodies with professional membership act on a collegial basis in most of their activities and only on certain highly sensitive issues does it become necessary for members to act as "government representatives". With regard to the "representativeness" of the forum, as with other United Nations subsidiary bodies, any policy recommended by the forum would need to be endorsed by the higher bodies of the United Nations, in this case by the Economic and Social Council and the General Assembly. It should be possible, therefore, to have a legitimate and fairly representative forum and to keep it small enough to operate effectively and economically. Moreover, in the transitional period, the forum could maintain its current membership. It was also noted that the Group of Experts has regularly invited observers to attend its meetings and to participate in its proceedings and that observers have made valuable contributions and could continue to do so under the proposed forum.

72. In light of the above, and pursuant to the General Assembly resolution 58/230, the following approach for a possible enhanced, intergovernmental forum might be taken into consideration by the Economic and Social Council when it gives consideration to the institutional framework for international cooperation in tax matters:

(a) *Size and composition.* The size and composition for an enhanced forum could remain generally unchanged from that of the present Group of Experts. As a transitional measure, the existing membership of the Group of Experts could be carried over to the meeting in 2005, with arrangements made after that for election/rotation of membership in accordance with the practices established by the Economic and Social Council for other similar subsidiary intergovernmental bodies;

(b) *Mandate and operations*. The forum should be expected to make recommendations to the Economic and Social Council on international tax matters, including the formulation of norms and the promotion of cooperative policies and practices as well as the provision of advisory services and technical assistance in this area. The forum would continue to be the custodian of the United Nations Model Tax Convention and Commentary, providing revisions to the model and commentary as warranted, and would cooperate with other international and regional organizations on international tax matters. It would meet at least once a year and would endeavour to hold technical, focused meetings at more frequent intervals;

(c) *Technical support*. The forum would require a small, competent and effective secretariat staff. Resources for the secretariat may be obtained through the reallocation of existing resources in the United Nations, which would remain part of the Department of Economic and Social Affairs. Among its duties, the staff could help organize technical assistance projects on international tax matters and collect and help disseminate information on tax policies and practices in collaboration with other relevant international entities.

XI. Agenda, time and venue for the next meeting

73. The proposed agenda for the twelfth meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters (or for the first meeting of an enhanced body) is:

(a) Treaty abuses and treaty shopping.

(b) Mutual assistance in collecting of tax debts.

(c) Earnings stripping.

(d) Modified permanent establishment definition.

(e) Taxation of income derived by participants in development projects.

(f) Revision of the United Nations Model Double Taxation Convention between Developed and Developing Countries.

(g) Review and adoption of the revised draft *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries*.

74. The twelfth meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters (or the first meeting of an enhanced body) should take place in the fourth quarter of 2005, at Geneva.

Notes

[1] A/58/216, para. 167.